104

MMS'S ROYALTY-IN-KIND PILOT PROGRAM

Y 4.R 31/3:104-82

MMS's Royalty-in-Kind Pilot Program...

HEARING

BEFORE THE

SUBCOMMITTEE ON ENERGY AND MINERAL RESOURCES

OF THE

COMMITTEE ON RESOURCES HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

SECOND SESSION

ON

THE MINERAL MANAGEMENT SERVICE'S NATURAL GAS ROYALTY-IN-KIND PILOT PROJECT CONDUCTED ON THE GULF OF MEXICO LEASES IN 1995, THINGS LEARNED, INSIGHTS GAINED FROM TEXAS PROGRAM, AND POSSIBILITY OF SECOND PROGRAM

JUNE 27, 1996—WASHINGTON, DC

Serial No. 104–82

Printed for the use of the Committee on Resources

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MMS'S ROYALTY-IN-KIND PILOT PROGRAM

THURSDAY, JUNE 27, 1996

HOUSE OF REPRESENTATIVES, SUBCOMMITTEE ON ENERGY AND MINERAL RESOURCES, COMMITTEE ON RESOURCES,
Washington, DC.

The Subcommittee met, pursuant to call, at 2:11 p.m., in room 1324, Longworth House Office Building, Hon. Ken Calvert (Chairman of the Subcommittee) presiding.

STATEMENT OF HON. KEN CALVERT, A U.S. REPRESENTATIVE FROM CALIFORNIA; AND CHAIRMAN, SUBCOMMITTEE ON ENERGY AND MINERAL RESOURCES

Mr. CALVERT. The Subcommittee will come to order. The Subcommittee meets to continue our oversight of Federal oil and gas resource programs in an effort to improve efficiency and enhance revenues to the Federal and State treasuries.

Today's hearing will review the Mineral Management Service's natural gas royalty-in-kind pilot project conducted on Gulf of Mexico leases during 1995, what the agency and the gas producing and marketing industry have learned from the pilot, what insights we might gain from a royalty-in-kind program in the State of Texas, and what plans exist to expand a second pilot to onshore lease, as well as on the OCS.

On Federal lands, including the Outer Continental Shelf, OCS, lessees must pay a portion of their production value, usually 1/8 onshore or 1/6 offshore, in the form of a royalty to the Federal Government. Valuation of production is a complex and burdensome process for lessee and lessor alike, which has resulted in years of costly litigation. A seemingly obvious way to avoid the valuation quagmire is for the royalty owners to take their fraction "in-kind" rather than "in-value."

On a small scale, this conjures up images of a West Texas rancher taking his or her natural gas directly into a sod house for domestic heating and cooking use and maybe warming the stock watering tanks in the winter to keep them from freezing. At the other end of the spectrum, recognizing that the Federal Government is the largest royalty owner in the country, would be a quasi-governmental corporation marketing the Feds royalty-in-kind product.

Of course, it is not too realistic to believe a Federal Government oil or gas company will be created by this or any future Congress I can foresee, so the question remains what is to be gained by the MMS taking gas in-kind. Because the Treasury still needs dollars, not BTUs, there has to be a point at which the royalty-in-kind

product, be it natural gas, or oil, or any other Federal mineral, is converted to cash.

A possible exception would be to heat and generate electricity for Federal facilities from royalty gas or oil. A small-scale example of this is going on in Alaska today where a small natural gas field in the NPR serves a military installation and the village of Barrow.

Our witnesses today will give us their insights so that Congress might direct further efforts to expand the RIK programs, or redirect their focus if necessary, in order to achieve a net gain for the taxpayers. By net I mean, receipts flowing into the Treasury minus the Federal Government's costs associated with producing those revenues, including auditing and the enormous legal costs to argue valuation decisions through administrative and judicial Courts.

I understand the ranking member, Mr. Abercrombie, is going to be here shortly, and so I am sure he will have an opening statement. But in the interim, I would like to welcome our witnesses. And, first, I would like to introduce Cynthia Quarterman, Director of the Minerals Management Service, and Stroud C. Kelly, Special Counsel for Energy Policy, Texas General Land Office. If you would like to come up to the table and take your seats.

Before you testify, I am sorry. I didn't see my colleague, Mr. Thornberry, arrive so I would like to recognize Mr. Thornberry for any opening statement.

STATEMENT OF HON. WILLIAM THORNBERRY, A U.S. REPRESENTATIVE FROM TEXAS

Mr. THORNBERRY. Thank you, Mr. Chairman. This seems to me to be one of those issues that makes so much sense that Washington has a hard time getting it done. And I realize that getting into the details of some of this is where the rub is, but it does seem to me that allowing royalty-in-kind to exist makes a lot of sense, and I think this is an area where we have a lot to learn from what some of the States have done. And I am particularly pleased that we can learn something about the Texas example here. And I look forward to hearing from the witnesses and hearing their comments about what we need to be doing.

Mr. CALVERT. Thank you, Mr. Thornberry. First, I would like to introduce Cynthia Quarterman, the Director of Minerals Management Service. I hope you will have more fun on this panel than the last group you were at earlier this week. Ms. Quarterman.

STATEMENT OF CYNTHIA QUARTERMAN, DIRECTOR, MINERALS MANAGEMENT SERVICE

Ms. QUARTERMAN. Good afternoon. Thank you, Mr. Chairman, Mr. Thornberry. I hope I have as much fun at least, if not more. I appreciate the opportunity to appear today to present testimony on the royalty gas marketing pilot which was implemented by the Minerals Management Service during 1995. The pilot was one of the National Performance Review laboratories implemented by the Department of the Interior and represents one of our many efforts to provide better service to the public at reduced cost.

The MMS gas pilot was conducted from January 1 through December 31 of 1995 and tested the concept of the Minerals Management Service taking the Federal Government's royalty share of gas

production in-kind from offshore Federal leases and selling the gas at or near the leases to competitively chosen gas marketing companies. The royalty gas was provided by 14 lessees on 79 leases who volunteered to participate and helped us to design the pilot.

The MMS had two objectives in conducting this pilot. The first was to find processes for streamlining royalty collections in a manner that reflects changes that have occurred in the gas market; and the second was to test the process for royalty collection that promises increased efficiency and greater certainty in valuation. We are pleased with the results of the pilot. It has provided the information that we required to evaluate the potential for using in-kind royalty gas for collection.

During the pilot, MMS took, in kind, approximately 45.6 billion cubic feet of gas, totaling over six percent of the Federal Government's royalty share in the Gulf of Mexico and sold it to gas marketing companies. The marketers were responsible for all costs downstream of the points of delivery. They also retained all the proceeds from selling the gas to their customers in a free market environment.

The MMS plans to issue a report on the pilot results later this summer. My testimony today will address only the main conclusions from the report. We will provide the committee with a copy of the report as soon as it is completed. Based on the results of the pilot, MMS is considering whether to pursue additional royalty-in-kind pilot efforts and, if so, how and where to conduct them. We will keep the Congress informed of our progress as we go along.

Again, in general, we are pleased with the results of the gas pilot. The pilot was an operational success. The fact that MMS designed and evaluated the pilot in collaboration with its customers was a critical factor, I believe, in the pilot's success. We are still working on the revenue impact analysis for the pilot. Our preliminary estimates indicate that there was some revenue loss from the pilot.

We are also conducting an analysis to estimate the internal MMS administrative cost savings that can be achieved through implementation of the pilot on a more global basis. We expect that participating lessees would also realize savings through reductions in reporting requirements, audit interface, and litigation if the pilot were expanded.

MMS learned several lessons from the pilot, including the necessity to allow more lead time before proceeding, both on our part and on the part of those who participated in the pilot with us; to provide additional information to bidders during the bidding process; and to start well before the winter season begins if a future pilot goes forward.

In conclusion, I would like to emphasize that the pilot presented the true spirit of MMS's efforts to find ways to make our royalty management efforts more efficient and less burdensome for the industry. We worked with industry to design an efficient program that reflects procedures that have evolved in the industry and serve both their needs and ours.

We have also been encouraged by industry's willingness to work with us in evaluating the results of our combined efforts. At the same time, however, we have sought to structure the pilot in such

a way as to ensure a fair return to the public from production of its resources. And that is something that we have to keep in mind as we move forward with any future royalty-in-kind efforts.

We are evaluating the results of the pilot carefully to see how we can best move forward to reduce costs, both for government and for industry, without compromising royalty collections. Those conclude my prepared remarks. I would be happy to answer any questions any of the members might have. Thank you.

[Statement of Ms. Quarterman may be found at end of hearing.]

Mr. CALVERT. Thank you, Director Quarterman. Next, Stroud Kelley, Special Counsel for Energy Policy, Texas General Land Office. Mr. Kelley.

STATEMENT OF STROUD C. KELLEY, SPECIAL COUNSEL FOR ENERGY POLICY, TEXAS GENERAL LAND OFFICE

Mr. KELLEY. Mr. Chairman and members, Texas Land Commissioner Garry Mauro appreciates the invitation to appear before you to discuss the Texas royalty-in-kind program, and he regrets that he is unable to be here. He asked me to speak on his behalf.

The Land Office has been pleased with the results of our in-kind gas program. We are glad to share that information with you. While royalty in-kind may not cure all of the disputes that arise between royalty owners and producers, our experience in Texas is that the in-kind program provides a means to substantially reduce royalty disputes, reduce costs to both the State and the lessees, and provide the State an opportunity to obtain an enhanced return by actively participating in the natural gas marketplace.

For those of you who are not familiar with the General Land Office, please allow me to explain briefly our role. The Land Commissioner, who heads our agency, is an elected official. One of his main duties is to manage the more than 20 million acres of public lands and minerals owned by various Texas government departments, most prominently, the Permanent School Fund, a trust fund that supports public education in Texas.

Annual mineral revenue from the fund is some $150 million, and although that is not large by Federal standards, it has nonetheless allowed Texas to create a public school endowment worth over $11 billion. The approximately 33 billion cubic feet of natural gas that represents our annual royalty share would rank the school fund as the 43rd largest producer of natural gas in the United States.

Over the past 10 years, the Texas gas in-kind program has enhanced royalty income for our Permanent School Fund by over $9.8 million, saved State agencies over $85 million in gas utility bills, and saved untold thousands of dollars for the General Land Office and gas producers by eliminating the need for royalty accounting for those volumes of gas taken in-kind. The program's past success has led us to expand the program through a new public-private alliance that I will describe for you in a few minutes.

The Texas in-kind program began in the early 1970's and has expanded to its present form. Since '85, the program has concentrated on sales to State agencies, universities, and other public facilities. The goals of the program are twofold: first, to enhance income from the school fund, and, second, to reduce gas costs to State facilities

by providing State gas at prices below those charged by gas utilities.

The Texas Legislature has consistently supported the program and, in recent years, has enacted laws that assure its smooth operation. One such statute requires all State agencies that consume more than 100 Mcf of gas per day to submit all of their gas acquisition contracts to the Land Office for review.

If the Land Office is able to provide gas at the same or lower cost, it may require the agency to purchase gas from us. Another supportive statute requires all regulated gas utilities to provide transportation of State gas if capacity is available. Transportation rights are generally competitive with those provided to private parties.

At present, the Texas program sells approximately 8.7 billion cubic feet of gas per year to State agencies and another 3.6 billion cubic feet on the spot market. Gas is currently being taken in-kind from 105 leases, most of them on the upper Texas coast. End-user sales contracts are in place with 101 State facilities, 27 State colleges and universities, and 7 other government bodies, including school districts and small municipalities.

Transportation contracts are currently maintained with 27 different pipelines and local gas distributing companies. And we also maintain a contract for up to one billion cubic feet of natural gas storage at a facility near Houston.

Sales of gas on the spot market are made through monthly solicitations of interest from prequalified gas marketers of whom there are currently 12. In order to qualify, marketers must show financial stability. But in addition to that, to encourage small business participation, the Land Office maintains credit risk insurance.

Since 1973, all State leases have provided for in-kind takes, and we have negotiated in-kind rights for some older State leases. Once we have exercised our right to take in-kind for a particular lease, we make every effort to continue to take gas from that lease in order not to burden the lessee by alternately going in and out of the take. We generally take possession of the gas at the point at which it has been made ready for sale or commercial use at the producer's cost.

In our end-user program costs of transportation and other costs, together with a markup for enhancement, a set administrative fee is charged to the gas purchasers. In all but a few cases, prices to the end-user agencies are significantly below those available from private sources and are lower than local utility costs in almost every instance.

Gas producers on State lands have been almost uniformly supportive of our program. Although I do not have specific figures, the administrative savings and other benefits to both producers and the Land Office are clear. It is far easier to account for volumes of oil or gas physically delivered than it is to account for both the volumes delivered and the market value of those volumes.

The in-kind programs have been successful, and we are now, as I have mentioned, starting the process of revising and more than doubling our gas program. The changes in the natural gas marketplace—may I extend my remarks?

Mr. CALVERT. Without objection, so ordered.

Mr. KELLEY. Thank you. We believe we can form a public/private alliance with a gas marketing firm that will bring together the very specialized expertise of gas marketers together with gas supply and markets that our office can provide to the benefit of both the State and the private marketer.

We have invited over 60 gas marketing firms to submit proposals by July the 8th covering management of our end-user program, creation of a natural gas liquids program, and the purchase of the balance of our natural gas supply at an index plus basis.

It is in the context of proposed expansion of our in-kind gas program that the State is seeking a way to obtain royalty provided for—royalty in-kind as provided—that we now provide for in cash under the Outer Continental Shelf Lands Act. We estimate that should that be able to be done, the 8(g) volumes would increase our available volumes by approximately 10 to 15 percent.

There apparently are some legal questions about the authority of the Secretary to deliver this gas in-kind, and we are eager to work with you to see if these questions can be removed and the authority of the Secretary to do so clarified.

We believe that the additional pilot programs that include State participation are a very valuable step in this direction. Mr. Chairman, we appreciate your efforts to include in the Interior appropriations process language that would establish a cooperative in-kind pilot program with a coastal State.

In conclusion, I would say that in-kind royalty is worth the consideration of any royalty owner that has the opportunity to take marketable volumes of oil or gas or has the opportunity to join with others in doing so. We look forward to working with you to encourage such programs.

Mr. CALVERT. Thank you, Mr. Kelley. First, I would like to direct a question to Director Quarterman. I appreciate your assessment about MMS needing to find ways to remove itself from the complex issue of valuation of oil and gas produced from Federal leases, and I think most of us would agree.

Back in what some may view as the good old days of regulated wellhead prices and pipeline purchases of natural gas, the audit job was relatively easy. But we all know that deregulation is here to stay and rightly so as competition in the marketplace is essential to bring about more competitive prices.

Many predict that the electricity business will follow next, and several energy companies are posed to enter that market when it is open. So it seems that gas valuation for royalty purposes will probably even get more complex unless such steps as RIK are taken. Do you agree that that would occur?

Ms. QUARTERMAN. Well, I think the valuation of gas has already proved to be quite complex in the past and with deregulation has become even more complex. That is why we have come forth with the RIK pilot. It is also why we put together the Federal gas valuation negotiated rulemaking team to try to reach some sort of consensus about the way the gas should be valued going into the future. So, yes, I do agree that valuation has become extremely complex. However, I don't think we should rush to any one conclusion in how to proceed in the future.

Mr. CALVERT. Your testimony mentioned the preliminary estimates indicate some relative loss, and you also mentioned that because of the complexity of valuation that it may be impossible to know, but, more importantly, does the estimate include a factor for the diminished cost of auditing and legal costs that the permanent RIK program would engender. You mentioned that briefly. Is there a percentage now that you know what your accounting costs, your legal costs are in association with your total costs?

Ms. QUARTERMAN. That is one of the things that we have been working on, trying to determine what the administrative costs are that MMS has. We had an early estimate that, frankly, was not quite credible. That is why we have redetermined when the report would come out.

We had expected it to come out on Monday. It will probably come out later in the summer as we analyze that a little bit more thoroughly. I can't give you an estimate for how much money would be saved based on administrative costs. But, in any event, it would not be enough to offset the losses that we have seen thus far in the pilot program.

Mr. CALVERT. It will be interesting to see the results of that as soon as they are available. Mr. Kelley has sung the praises of RIK for Texas leases, but then they had a fully operational program for well over a decade. And Texas is a value-added business, as well as aggregating value and was using it at State government facilities and doing its own marketing gas access to those needs. Has there been any discussion with the Interior Department or with the National Performance Review staff to consider such additional functions for MMS?

Mr. KELLEY. Mr. Chairman, as you know, our former Land Commissioner is Assistant Secretary, and his assistant formerly ran our gas program as well. We have not had formal discussions. We have had some informal discussions and are certainly willing to offer any assistance if we can.

Mr. CALVERT. Ms. Quarterman, do you have any comments on that?

Ms. QUARTERMAN. I should add before we started the pilot, some folks from MMS's staff did meet with Texas because we realized that they were doing something very similar to determine whether we should pattern our program precisely after theirs or do a variation of that. So we have talked to them. I don't think we have talked to them since the program has been completed, but it is something that we certainly should do.

It seems that they are going on a different direction that might be closer to what we have done in the past and might be interested in doing in the future. So we plan to continue discussing with them the RIK program.

Mr. CALVERT. Thank you. Mr. Kelley, what legislative changes, if any, are needed in order for a State to take its portion of royalty-in-kind gas from leases in the 8(g) zone?

Mr. KELLEY. Mr. Chairman, the Outer Continental Shelf Lands Act is not terribly clear on the point. Our view, of course, is that the delivery of in-kind gas would be the equivalent of a delivery of revenue. However, we think it would be very helpful to have express authority for the Secretary to authorize 8(g) producers to de-

liver the State royalties' fraction in-kind certainly under arrangements that would need to be worked out with producers and with MMS.

Mr. CALVERT. Your interpretation of fair market value, in other words, is the value that Texas receives for its portion of royalty gas?

Mr. KELLEY. Yes, sir. Under our view, that the delivery of the correct royalty fraction is equivalent to the—fully satisfies the royalty obligation, obviously, subject only to audit for volumes and not for value.

Mr. CALVERT. So Texas does not look beyond its volumetric portion of in-kind gas for the royalty obligation?

Mr. KELLEY. No, sir. When we receive our volumes, we consider the royalty obligation satisfied.

Mr. CALVERT. Thank you. Mr. Thornberry.

Mr. THORNBERRY. Mr. Kelley, did I understand from your testimony that in the past 10 years this royalty-in-kind in Texas has significantly increased the royalties that the State has received as far as the oil and the gas, as well as saving utility bills?

Mr. KELLEY. We have an oil in-kind program as well. Both programs we feel have enhanced our royalty values beyond what we would have received had we been made simply a cash royalty, as well as saved considerable administrative overhead.

Mr. THORNBERRY. Have you made any attempt to quantify the administrative and legal fee savings? Do you have any estimates for us on that?

Mr. KELLEY. We have not reduced that to dollars. I can tell you that I personally am involved in, as counsel, to the audit program, and we spend—we have approximately 20 auditors. We have several lawyers dedicated solely to that function that we could put to doing other tasks if we were to go entirely to an in-kind program. So the savings would be considerable.

Mr. THORNBERRY. We talked a little bit about cooperation with the Federal pilot program. Have you examined the Federal pilot program, and do you have comments on what they did right or suggestions on how they can improve things?

Mr. KELLEY. We have not, but we look forward to seeing the report because as the Director said, we are moving more in that direction into a public/private alliance with a marketer. And we are very pleased that that model is there that we can look to.

Mr. THORNBERRY. But you haven't looked at it yet?

Mr. KELLEY. Have not.

Mr. THORNBERRY. Would the State be willing to accept responsibility for the gas at the wellhead?

Mr. KELLEY. We would have to look at that. Under our present scheme, as I testified, under our leases, the lessees are obligated to take the gas generally to a point post-processing. But, again, we view the gas takes as almost on a lease-by-lease basis and what is appropriate and what would work and turn a profit for us in our program.

Mr. THORNBERRY. In answer to one of the Chairman's questions, you were talking about your view is the royalty requirement is met regardless of the value as long as the volume of gas is delivered. Is that correct?

Mr. KELLEY. Yes, sir.

Mr. THORNBERRY. And so do you have some difference of opinion as to where it is delivered or does that matter?

Mr. KELLEY. Well, it does matter clearly in terms of cost.

Mr. THORNBERRY. Sure, but I am talking about as far as where the obligations are.

Mr. KELLEY. We construe our State leases to require the producer to put the gas in marketable condition before delivery as royalty. That is a parallel obligation we view in terms of cash royalty as well, that those are nondeductible costs. Clearly, if we were to participate on Federal leases, that would be something that would have to be worked out under Federal requirements. And, generally speaking, if we felt the gas could be profitably taken into our system into our program at the wellhead, I am sure we would be willing to do so.

Mr. THORNBERRY. But you have not looked at that at this point?

Mr. KELLEY. We have not studied that. We have mostly been spending our effort getting our expanded program ready under our regulations and our scenario.

Mr. THORNBERRY. OK. But you are not ruling it out either? You don't rule it out, do you?

Mr. KELLEY. No, sir. We would not rule that out.

Mr. THORNBERRY. OK. Ms. Quarterman, we heard Mr. Kelley mention he believes there ought to be a clearer provision in the law to provide for a royalty-in-kind. Tell me, in the 8(g) zone what is your view as to what the law allows now and what would be required to make it clearer, if we need to do that, to permit a State such as Texas to receive our gas in that zone and in-kind?

Ms. QUARTERMAN. My understanding of what 8(g) provides right now is that States can share 27 percent of the revenues. Our solicitor has looked at that and determined that he believes that it would require a change in that language so that the State could take it in-kind. I believe that we have worked with the State to come up with language that is acceptable to us to achieve the goal that the State wants to have happen.

Mr. THORNBERRY. Well, is this something that you and the Department supports, or are you somewhat reluctant to allow Texas and perhaps other States to take their royalties-in-kind?

Ms. QUARTERMAN. Well, since there hasn't been any legislation that came forward, officially, I cannot give you an official Administration or Department position. I think as a practical matter we like the idea as we have piloted ourselves of States having the opportunity to do things more flexibly.

The only caveat that I would put there is that in doing so, the Secretary and the Department be given some flexibility so that we aren't put in an awkward position with our lessees, and we don't get in a situation that might administratively not be workable. But I don't foresee that as being a problem.

Mr. THORNBERRY. But you are not here to testify that because the current Federal pilot program has not made as much money as we would like that that was run perfectly? As a matter of fact, you have listed in your testimony a number of lessons that were learned where improvements could be made. You still think there are problems, in other words, to take this approach?

Ms. QUARTERMAN. Absolutely. I think we learned quite a few things that we would do things differently, and that is precisely why we did it as a pilot to see what we could learn. I think there are ways that the pilot could be improved. Whether or not we would ever reach the point where we were revenue-neutral is something that I think I and my staff have to sit down and thresh through for a while.

There are some concerns that we have about the extra burden that would be placed on the government in marketing the gas that it does not have now. Right now, the producer markets that gas, and any value associated with that is given to us in dollar terms.

If we take it in kind, we do take some of that responsibility. Either we can do it, which would offset the administrative savings, or we could hire someone else to do it, which is what we did in this instance and I think is reflective of lower values that we got.

Mr. THORNBERRY. Mr. Chairman, if I might ask one more question? In listening to what has happened in Texas, is there anything so fundamentally different in the Federal structure that would change necessarily the results that they have received? Because Mr. Kelley has testified that they feel like they have had enhanced royalties and savings, you know, under the Texas system utility bills, plus the administrative and legal costs. Is there anything that is so fundamentally different in the Federal system that would preclude us from getting those results as well?

Ms. QUARTERMAN. Well, I haven't studied the Texas lease terms or statutes in any detail so I hesitate to respond. I would say that I think there may be some differences in the transportation terms between the Federal and State leases wherein in the Federal leases we may not be able to require or have not so far at least required companies to take gas or oil at a point further without then allowing them a transportation allowance.

And I am not sure the State may have the ability to do that, as well as a little bit more ability in terms of marketable—putting things in marketable condition. So there may be a few differences.

Mr. THORNBERRY. Well, that is exactly the sort of thing that I think is helpful for us to know because that could affect the cost, of course, if you have got to pay an allowance to take it on further down the line. I appreciate that. Mr. Chairman, I may have some other questions that I would like to submit along that line, and if I may do so for the record, I would appreciate it.

Mr. CALVERT. Certainly. I have just a question following up with Mr. Thornberry for Mr. Kelley. Do you have any suggestions that could assist the MMS in an in-kind program which would increase revenue?

Mr. KELLEY. We would certainly welcome the opportunity, and I am sure we will have the opportunity to look at theirs and offer any suggestions we might have and also learn from their experience in a program that looks a whole lot more like the one we are moving toward. Without studying their experience in more detail, I don't think I would have anything specific at this time.

Mr. CALVERT. Thank you. Mr. Thornberry, any questions right now, or would you like to submit your questions later in writing?

Mr. THORNBERRY. I would like to submit my questions. But let me be a little clearer about this. Who is moving toward whom? It

seems to me if you all are making money and you all haven't yet, you need to move that? Am I missing something?

Mr. KELLEY. Well, we are, as I said, moving toward that kind of program in terms of using a private marketer in a public/private alliance. We have been very fortunate in that we have had an end-user enhanced value market for most of the gas that we have taken. And we are hopeful that, of course, that part of the program will continue.

It is the additional volumes of which at this point we do not have a clear market and which we intend to sell in the open market on an index basis—hopefully an index plus basis that we hope will make progress. We will have one provision that I think will give us some assurances on premium priced gas where our marketer will not be entitled to a take on that gas, but they would have to match the price if there is a high price contract in place for a particular well.

Mr. THORNBERRY. But as I understood your testimony, you all are already marketing what?—a fourth of the gas on the spot market now?

Mr. KELLEY. Yes, sir.

Mr. THORNBERRY. OK. Thank you.

Mr. CALVERT. Thank you. I would like to thank this panel for your testimony and for your answers. And you may receive some more questions that ask for your written replies which will be made part of the record.

Next, I would like to ask the next panel from the industry to come forward; Mr. Andrew N. Hoyle, the Vice President of Marketing, Enron Oil and Gas Company; G.S. Patterson, Manager, Gas Plant & Property Management, Amerada Hess Corporation; and Larry Nichols, President of Devon Energy. Please come forward and take your seats at the witness table. I would first ask Mr. Hoyle from Enron to go ahead and begin your testimony.

STATEMENT OF ANDREW N. HOYLE, VICE PRESIDENT, MARKETING, ENRON OIL AND GAS COMPANY

Mr. HOYLE. Good afternoon, Mr. Chairman. I am Andy Hoyle, Vice President, Marketing, Enron Oil & Gas Company. Enron Oil & Gas Company is owned approximately 60 percent by Enron Corp, and is one of the largest independent nonintegrated oil and gas companies in the United States in terms of domestic proved reserves. In addition, it is the operator of substantial reserves in Canada, India, and Trinidad. The company's year-end 1995 reserve base was 88 percent in North America and 92 percent natural gas.

I thank you for the opportunity to testify on the role of Enron Oil & Gas as a participant in the royalty-in-kind pilot program conducted by the Minerals Management Service in 1995. I will discuss the program from the point of view of Enron Oil & Gas as a producer of natural gas from MMS leases.

I will also include comments on behalf of Enron Oil & Gas Marketing, Inc., a marketer which buys and resells natural gas and was the willing bidder for the MMS's royalty gas from the Enron Oil & Gas company's leases.

Enron Oil & Gas volunteered for the RIK pilot program five leases offshore the Gulf Coast of Texas in the Matagorda Island

area. Enron Oil & Gas's ownership in these leases vary from 61 percent as a low to 89 percent as a high. And also Enron Oil & Gas is the operator of the producing facilities serving those blocks.

As far as the volumes produced and marketed in 1995, we have summarized those volumes into two groups; one group of Matagorda 500 blocks, if you will, with their share of the gas average for 1995 4,380 MMBTUs per day, and on the Matagorda 620 and 638 blocks, MMS volumes averaged 7,450 MMBTUs per day. You add that up, and you come up with something shy of profiles of MMBTUs per day.

What are the benefits of the program? We believe the major administrative benefit of the pilot program should be to reduce the MMS audit requirements, mainly involving valuation issues. We have found that resolving valuation issues during an audit takes a significant amount of administrative time and effort.

Another potential benefit of the program we identified was the MMS's waiver of the onerous requirements of Section 10 of the Outer Continental Shelf Lands Act for refunding overpayments by the producers to the MMS.

The program would seem to provide yet another benefit to the producer because the administrative responsibility for filing MMS 2014 forms was, on paper, shifted from the producer to the marketer. Unfortunately, marketers at this time were typically unfamiliar with these forms and the reporting requirements.

Thus, the producer was still involved in the process and was required to provide the marketer with information involving detailed volume allocations. This negated the producer's benefit of not filing MMS 2014 forms, but, perhaps over time, the marketers' familiarity with these forms could ease the producers' input into the overall process.

Unfortunately, the pilot program also required additional reports from the producer that would offset some, if not all, of the administrative benefits previously discussed. For example, the MMS required the producer to complete a Royalty Gas Imbalance report which was required to be submitted to the MMS and the market.

The producer was further required to provide the MMS a monthly report which included detailed volume and pricing information so that the MMS could evaluate the revenue neutrality of the program.

As far as the marketing contract goes, it was unlike most industry contracts in that certain provisions were very one-sided in favor of the Minerals Management Service. The majority of the industry agreements between Enron Oil & Gas and the marketers have provisions that are reciprocal in nature, meaning the penalties will affect either party if nonperformance occurs.

If the marketing contract offered under this program had been submitted by an industry entity instead of the MMS, neither Enron Oil & Gas nor Enron Oil & Gas Marketing would have executed the agreements because of its strong bias for the other party. Generally, the provisions where this bias was most prevalent were, first, penalties for the marketer's failure to take 100 percent of the gas volume; secondly, indemnification of the MMS for any penalties due to gas pipeline imbalances; and, finally, the right of the MMS to terminate the contract anytime without liability.

How can the 1995 pilot program be improved? One thing would be to mandate that all producers or owners in the blocks participate in the program. This will allow the operator to handle MMS volumes similar to the volumes of other owners. And in my written testimony, I have one more suggestion involving the gas contract, but I would like to go to the final paragraph if I could please. One more comment.

As a producer and marketer, I can only support expansion of the pilot program if the expansion includes elimination of administrative burdens imposed by the MMS during the pilot program. I fully support the idea of reduced MMS audit requirements which could virtually eliminate valuation issues.

However, if the MMS continues to require producers and marketers to prepare reports outlined in this presentation, I fear that both the industry and the MMS would incur significantly higher costs. If the pilot program is expanded, MMS would need to increase its gas marketing expertise.

In today's unregulated environment, the MMS needs to develop competent expertise in all producing and marketing issues from the wellhead through the pipeline delivery point. If the MMS does not want to invest in gaining more expertise, but would prefer to expand the program utilizing basically the same concepts and onerous agreements as the pilot program, I believe the current program would be difficult for both producers and marketers to accept.

Not only would it increase the producers' and marketers' costs of operations, but I believe it would be grossly unfair for the MMS to mandate such requirements in order to shield the agency from the realities of a pipeline and marketing environment largely created by its sister agency, the Federal Energy and Regulatory Commission. Thank you, Mr. Chairman.

Mr. CALVERT. Thank you for your testimony. Mr. Patterson, Manager, Gas Plant Supply & Property Management, Amerada Hess Corporation?

Mr. PATTERSON. That is correct.

Mr. CALVERT. You may begin your testimony.

STATEMENT OF G.S. PATTERSON, MANAGER, GAS PLANT SUPPLY & PROPERTY MANAGEMENT, AMERADA HESS CORPORATION

Mr. PATTERSON. Well, in June 1994, the MMS approached Amerada Hess and asked us, among others, to participate in the gas pilot in the Gulf of Mexico. We participated by pumping, to some extent, with the contracts on both sides. They asked for our comments, and we gave them there. We also participated by offering three offshore leases for the pilot, two of which were accepted. As a marketer, Amerada Hess bid on 23 groups of leases, and we were a successful bidder on one.

Overall, I would say the MMS did an excellent job in designing and implementing the pilot. By getting input from the industry to start with, they avoided a lot of problems. It got off to a very good start. I really don't know if it was successful or not because I haven't seen any of the results yet.

With respect to the two leases that Amerada Hess had in the pilot, the economic results were not favorable. The MMS lost about

14 cents per MCF on the gas that was provided in-kind versus the revenue they would have received under the conventional method. And I, once again, have no idea of what the offsetting administrative savings might have been.

There are a couple of specific things that could be improved. During the bidding process, information really was not available to the marketers with respect to the lateral lines. Those are the lines that go from the wellhead to the nearest large pipelines. And without that information, bidders were bidding in the dark. And I was working on this—the bids—the properties we put up, people did call me and ask me what the pipeline arrangements were, and it was a fatal mistake for some of them.

Another area, if after a marketer has bid on a property and the rules change; for example, if the FERC allows certain interstate pipelines to spin down their gathering assets and the marketers see higher fees, they can be in a situation where they will be forced into a breach situation, which wouldn't because they really weren't——

And, finally, if the MMS wants to go ahead with their extended pilot—second pilot or perhaps go on to putting all the offshore gas under something like this, I would suggest they do it over a period of time. Because overnight if they did it, it would be like 1/6th of the gas, which is pumping 2/BCF a day, would, in effect, disappear from the market in one respect, and the producers wouldn't have that gas to sell so the market companies would have it.

To the extent the producers had entered into long-term contracts for transportation or perhaps warranty contracts for the downstream, they would have to scramble to replace that gas. So certainly if we can do this, we want to do it over time, which gives the industry time to adjust.

A solution to that would be to allow the producer to have a last look at that marketer's bid and match it. That would be revenue neutral to the MMS, and it would give that producer a chance to keep his gas and continue to sell it. Those are my comments.

Mr. CALVERT. Thank you, Mr. Patterson. Larry Nichols, President of Devon Energy.

STATEMENT OF LARRY NICHOLS, PRESIDENT, DEVON ENERGY

Mr. NICHOLS. Thank you, Mr. Chairman. I am Larry Nichols, President of Devon Energy Corporation, an independent producer who has Federal production. I am here today on behalf of Devon and the Independent Petroleum Association of America, a national trade association with over 5,500 independent oil and gas producers. I will summarize my comments but request that the full written comments be made part of the record.

Mr. CALVERT. Without objection, so ordered.

Mr. NICHOLS. Mr. Chairman, we always appreciate the opportunity to work with you in the pursuit of a more efficient and cost efficient way of managing the payment of royalties. In June of last year, I testified before you on the need to reform the Federal royalty collection system. We personally want to thank you and the committee for responding by expeditiously moving the Royalty Fairness bill, and we appreciate your continued efforts on behalf of that bill.

Today, we are discussing another important initiative—reducing uncertainty associated with the payment of Federal royalties in today's natural gas market. We applaud the Minerals Management Service's recognition that alternative approaches need to be pursued to develop a more certain and a more predictable method of determining gas royalty payments.

Gas production is important to this country and is important to independents who produce 65 percent of domestic natural gas. We need to develop a Federal royalty system that encourages natural gas from Federal onshore and offshore leases and, as required by law, always looks to the free and competitive market between a willing buyer and willing seller as the basis for all royalty payments.

The gas market has changed radically in recent years. Historically, gas was sold at the wellhead by the producer at a regulated price. Payment of royalties, the calculation of royalties was very simple. A lot has changed over the last few years. Producers may now sell directly to industrial customers, to end-users, to local distribution companies, and other former interstate pipeline companies.

Producers must now also either build, in many cases, transportation lines to transport gas away from their wells or pay third parties to transport gas away from the wellhead for shipment to different markets.

We agree with a March 1996 MMS report which stated that in today's gas market, tracing proceeds from a point of sale back to a particular lease is very difficult, and determining the royalty value of gas produced from Federal leases has become increasingly complex and burdensome.

Additionally, we believe uncertainty increases costs once considered deductible as a cost for merchant services provided by a pipeline. Those are now being questioned and traced to distant markets for royalty purposes.

In response to the changes in the gas marketplace, the MMS has initiated two important efforts: one, a negotiating committee to update the rules for paying gas royalties and, two, a royalty-in-kind pilot. With regard to the rulemaking effort, IPAA supports finding an alternate valuation method for gas that does not increase administrative costs and eliminates the burdensome accounting now associated with gas processing.

With regard to the royalty-in-kind program, Devon volunteered one offshore lease. During that pilot, Devon was required to notify the government's purchaser of the volume of the gas that it was required to take. This additional communication and the new relationship with the MMS's purchaser appears to somewhat offset the administrative cost savings that occur by eliminating the current royalty calculation method.

On the other hand, a mutual benefit to both the government and the producer under any in-kind-type scenario is the certainty that is associated with delivering volumes in lieu of royalty payments. Once delivered, the royalty obligation under a lease is satisfied.

One question that is always asked is what is the market value? When taken in-kind, the market value is the price that the MMS

receives from the willing purchaser. This eliminates the audit burden, both on producer and on the government.

We compliment and encourage the MMS to continue to work cooperatively with the industry and the States to develop these alternatives to restore certainty and create simplicity for paying royalties on natural gas production. We strongly encourage the MMS to allow pilot participants an opportunity to comment on its draft to the report so that both producer and market reviews can be incorporated into that final report. To encourage additional pilots, my own company has volunteered gas for an in-kind onshore pilot.

Mr. Chairman, we support the legislative language that you submitted to the Chairman of the Subcommittee on Interior Appropriations authorizing the MMS to conduct additional in-kind pilots. If these pilots are conducted in a manner similar to your language, then all concerned parties will be able to make informed decisions about the future of such a program.

I want to inform the committee about a separate effort we have initiated to develop alternatives to the current system. As chairman of an advisory subcommittee for the MMS entitled Nonconventional Alternatives, we will attempt to develop payment options to reduce the royalty regulative burdens that are now associated with gas production.

As this committee's works are concluded, we will report back to you and the MMS on our efforts. We are available to work with this committee in pursuit of its attempts to simplify domestic natural gas production. Mr. Chairman, this concludes my prepared comments. Thank you.

[Statement of Mr. Nichols may be found at end of hearing.]

Mr. CALVERT. Thank you, Mr. Nichols. Mr. Hoyle, as a marketer, put yourself in the shoes of MMS for a second, and tell us what you could do with in-kind gas to increase revenue to the Federal and State treasuries.

Mr. HOYLE. I think if I were in the MMS's shoes, I believe that it is tough to market gas when you are a passive working-interest owner, in effect, at a block platform or a well. A company that operates has some advantages in marketing its gas because it knows what the volumes are.

But I think overall, a general comment, if I was the MMS, I would look and see where I have strengths or I have volumes concentrated on certain pipelines—large volumes—I would say in excess of 5,000 MMBTUs per day. The closer to 10,000 MMBTUs per day or greater, I think, would be better.

And that is just simply because you get to the lower volumes. If you think you get a higher price for the gas, it doesn't really have that much impact on the higher the volumes generally. You use a little more market clout in here. So I would, again, look in detail at the areas where I do have strengths—larger volumes—so I could aggregate those sources and be a bigger player in the marketplace on that pipeline system.

Mr. CALVERT. Mr. Patterson, regarding valuation, Director Quarterman testified that revenue loss on the pilot was not really known. You indicated that there was a 14 cents per MCF. Is this figure derived from your company's production—volunteered for RIK versus the price you sold the other 5/6th at?

Mr. PATTERSON. Yes. That was just restricted to the two leases that Amerada Hess had with the program.

Mr. CALVERT. So, obviously, this is your particular company, and, if so, you can't comment on MMS's loss throughout the entire pilot program, but certainly in your particular instance it was 14 cents?

Mr. PATTERSON. I have no idea whether there was a loss or gain on the rest of it.

Mr. CALVERT. What is that, sir?

Mr. PATTERSON. I said I have no idea if there was a loss or gain on the rest of the pilot.

Mr. CALVERT. OK. When various companies are bidding for business with MCF, do you think there is fear dealing with the Feds somewhat because of the bureaucracy or whatever the reason, and that translates into discounting as far as what they bid on as far as the gas that they are buying from the MMS?

Mr. PATTERSON. Well, from our perspective, it was something entirely new. We had never done anything like that so there was a little fear that we were getting into something we weren't familiar with—the bidding with a Federal agency. And also the contract that, you know, a marketer had to sign was pretty draconian. It was tough. You had to give a lot of thought to whether to bid or not, and then build in some extra money just in case you got in trouble.

Mr. CALVERT. Mr. Nichols, please tell us how expanding the royalty-in-kind program could benefit an independent operator such as Devon?

Mr. NICHOLS. Well, the primary benefit from any in-kind program is to create certainty so that you know what your role to obligation is and how it can be satisfied. By giving the government its share of royalty at the wellhead, you know with certainty on a timely basis that you have totally fulfilled your obligation. On the other hand, the current system has great uncertainty with it because of the valuation methodology and the complications that the MMS follows in determining the value.

Secondly is the cost benefit. The current system is very costly to the industry and very costly to the government because of all of the reporting and all of the auditing that needs to go on. A royalty-in-kind program holds out the promise to eliminate those costs or substantially reduce those costs and to add certainty. So I would say the establishment of certainty and the substantial reduction in cost holds out great promise to both the government and to the independent producer.

Mr. CALVERT. I think this question would be both for Mr. Hoyle and for Mr. Patterson. What are your suggestions to MMS for future pilots, would it be increase competitive bidding for the royalty gas? A similar question that I asked Mr. Patterson earlier. How do we get that number up?

Mr. PATTERSON. Better information. I think given more time to put your bid together, more time to contact the producer, find out how the wells are connected, and what pipelines they flow through, and not doing it starting in the winter would be a good idea. Those are a couple of items the MMS mentioned. Those would be the major ones I would suggest.

Mr. HOYLE. Mr. Chairman, I guess I would agree with what Mr. Patterson said, but I would also add that if MMS would want higher value or more bang for the buck or whatever you want to call it, that they might be willing to take some more risk in the marketing efforts with the marketers. Because marketers are basically in the business to make money, and they don't particularly care for risk either.

And the way the contracts are structured, the marketers really bore the brunt of the risk in marketing this gas, whether it was a pipeline imbalance or whatever. I think if MMS would maybe accept a little bit of that risk themselves and not try to push it off on other parties, that may enhance the prices that they could receive at the wellhead for their profit.

Mr. CALVERT. Again, for both of you, from your experience with the '95 pilot, are your companies willing to participate in future programs?

Mr. PATTERSON. We would participate again I think.

Mr. CALVERT. How about Enron?

Mr. HOYLE. Yes, sir, Mr. Chairman. We would participate in the program, but I would like to also add, if I may, that Enron Oil & Gas would like to work with representatives of the MMS at, you now, really a very early stage in designing the pilot and identifying the producing areas where they have strength, and then we can make the program really more reciprocal or beneficial for both parties. So we would like to be very much a part of that process.

Mr. CALVERT. Mr. Hoyle, Enron, of course, is certainly a very large company, and what are you?—the largest marketer of natural gas now in the world or right up there from what I understand. And Mr. Kelley testified as to the State of Texas's RIK program possibly being expanded to a public/private partnership for adding further value to their royalty gas.

That sounds like an invitation Enron certainly would—a company such as yours or probably Mr. Patterson's company also would certainly—be interested in. But your testimony with respect to MMS can be described as a little negative. Basically, what do you think that Texas has learned and the Feds haven't?

Mr. HOYLE. Mr. Chairman, I am not familiar with the Texas program. We don't have any leases or properties that participate in that effort so I really have no direct knowledge about really how the program is structured or designed and how it is implemented. I am sorry I can't help you there.

Mr. CALVERT. OK. Well, maybe you can put some thought into it. Maybe later on you can get back to us on that. Mr. Nichols, lastly, given that many independents continue to sell their production at or near the lease, what benefits and drawbacks do you envision under an in-kind scenario?

Mr. NICHOLS. Well, I think the benefits are demonstrated by the Texas program. If Texas has devised a program that is satisfactory with the industry down there and satisfactory with government and doing it in a cost-effective and adding certainty to the system, then one would certainly hope that the same principles could be applied on Federal lands.

Mr. CALVERT. Thank you for your answers, and now the ranking member, Mr. Abercrombie, has arrived. And so I would like to

allow him to make a statement and ask a few questions if he would like.

Mr. ABERCROMBIE. I have no statement, Mr. Chairman, other than to thank you for having the hearing and getting some of the information that has come forward since the experimental program went into existence to be put on the record. The only question I have—one or two questions—maybe are more in the way of observations. And you may have gone into this previously but perhaps could be amplified on.

Am I correct that essentially what happens if everything works out in the experimentation is that the uncertainties that are associated with trying to deduce exactly what costs can be legitimately assessed with respect to transportation processing, marketing, et cetera, those costs can essentially be eliminated—not the costs eliminated, but trying to assess the costs be eliminated, and you essentially get down to production in volume being, if not the singular, the essential element against which costs are assessed? Correct?

Mr. PATTERSON. Correct.

Mr. ABERCROMBIE. And you have had this experience now for is it a year? Is it a whole year already or approximately a year? '95 but I am not quite certain when it started—'95—'96. How long is the experience right now?

Mr. PATTERSON. The pilot was for 12 months.

Mr. ABERCROMBIE. OK. So it has been about 12 months now. OK. Four quarters. Now, inasmuch as there were, let us see, what?—about a quarter of the eligible companies participated in the experiment so far? Am I right?

Mr. PATTERSON. I don't know.

Mr. CALVERT. About six percent of the MMS production.

Mr. ABERCROMBIE. I am not sure of the total production. But, I mean, the number of companies. I think there are what?—150 or plus companies that might have participated in about 40 some companies. But let us say for all intents and purposes, other companies are watching you. Have you shared your experience so far with other companies? Have there been any other inquiries? I am speaking in industry exchanges of one kind or another.

Mr. PATTERSON. I have not.

Mr. NICHOLS. There certainly has not been any formal exchange. There is certainly a lot of informal exchange—anecdotal exchange.

Mr. ABERCROMBIE. Right. So has there been—and, again, I may have missed this—has there been a formal time in which there will be an assessment where everybody will sit down and try to offer their formal—aside from this hearing, has there been a formal presentation by the companies, say sponsored by MMS, where they come out and say, "Here is our evaluation"?

Mr. NICHOLS. Mr. Abercrombie, one of the points I made in my remarks was that the MMS is currently preparing a report, and I suggested that the MMS share a draft of that with the industry participants so that our own views could be expressed in that, and that that might provide a forum for——

Mr. ABERCROMBIE. No, I understand that. Right, and I agree with that. But there has not been done, say, a formal conference

or anything in which evaluations are presented for public consumption. Right? Unless I am mishearing?

Mr. NICHOLS. That is right.

Mr. ABERCROMBIE. OK. Do you think such a thing would be a good idea?

Mr. NICHOLS. Yes.

Mr. ABERCROMBIE. I don't think—you know, I am quite the opposite on the fence from Mr. Calvert, but I give him credit for having the hearing today. I am pleased we have had it, but I don't think a congressional hearing is the proper forum for a kind of roundtable—I guess is really what I am talking about—in which those of you who have been participating could perhaps present your various perspectives as to what has happened. Because I think that would be perhaps the most effective way for the other companies to get the benefit of your experience. Does that strike you as something that would be useful?

Mr. NICHOLS. I would agree with that and for the MMS to exchange its views on that subject too.

Mr. ABERCROMBIE. I am sorry. I missed the last——

Mr. NICHOLS. And for the MMS to exchange its observations.

Mr. ABERCROMBIE. Yes. In other words, a roundtable and then do some kind of report, and I don't really see the efficacy necessarily of having a report based on extraction rather than—you know, no pun intended—trying to extract a viewpoint as opposed to simply having people analyze what they have gone through, what they see the pluses and minuses, and try and go.

And if it is OK with the Chairman, I would like to suggest perhaps that we suggest, in turn, to the MMS and to the companies that have been involved in this that perhaps a roundtable discussion or something of that nature prior to reports being issued and all that be undertaken, and then that be made available, not just to us, but to the industry as a whole.

Mr. CALVERT. I don't oppose that idea. I understand that they are at the last ebbs and flow of putting together this report so it would have to be pretty quick.

Mr. ABERCROMBIE. OK. Well, then let me alter it. How about this, that once this report becomes available, how about sharing it with all the companies involved, get responses, and then perhaps hold a roundtable discussion on the papers that thus evolve, and then before you get to a final conclusion, that it comes, say, back to us?

Mr. CALVERT. Certainly. We will share that with Director Quarterman and see if we can't get some kind of——

Mr. ABERCROMBIE. Is there any disagreement among you folks as to that, generally? I am not saying that is definitive but something along those lines. You at least ought to be able to get a chance to respond or to comment or observe on such a report, don't you think?

Mr. NICHOLS. Absolutely.

Mr. ABERCROMBIE. And then perhaps the combination could be put forward in a general industry conference or roundtable or something of that nature. Because that is the best way I think, Mr. Chairman, in conclusion, that we can get the kind of feedback we need to make legislative activity useful and focused. Thank you.

Mr. CALVERT. Right. Certainly. And I think information is useful, but certainly through this hearing today we found out it has been very successful in Mr. Thornberry's State of Texas. And I think we can share that and hopefully move this program along. With that, I will introduce Mr. Thornberry to ask questions of the industry panel.

Mr. THORNBERRY. Thank you, Mr. Chairman. And I want to thank each of the witnesses on this panel for participating in the hearing today. Following along Mr. Abercrombie's line, it is kind of interesting, as I have tried to work on this issue, that some folks don't mind talking about it quietly, but they have some concerns even talking about the subject in a public way, which I have yet to figure out, but probably not the only thing.

Enron answered this question from the Chairman, but let me just check with the other two of you. Have you all had any experience with the State of Texas's program so that we can compare one program versus another?

Mr. NICHOLS. No. Our company has not.

Mr. PATTERSON. Nor has ours.

Mr. THORNBERRY. Do any of you have concerns and, if so, what are they, to a program that would be a mandatory royalty-in-kind gas program for, say, the 8(g) zone where you have to take your royalty-in-kind at the wellhead? Does anybody have any problems?

Mr. NICHOLS. Well, I think, you know, if the royalty-in-kind program can be developed to correct some of the problems and it works——

Mr. THORNBERRY. Yes, so we have got to deal with the administrative problems that Mr. Hoyle talked about, for example, and I think you talked about it as well. But if, say, we can reduce those administrative problems that maybe offset some of the advantages of a royalty-in-kind, is there any other reason that you can see or objections that you would have to that sort of approach?

Mr. HOYLE. Mr. Thornberry, if I could ask a question? Would that just be—when you say mandate, that would be like blanket?

Mr. THORNBERRY. It would apply to everybody.

Mr. HOYLE. It would apply to everybody?

Mr. THORNBERRY. It would apply to everybody.

Mr. HOYLE. Everywhere? The thing that concerns me a little bit about that is that every producing area has its own distinct, unique type of characteristics. It is not something that you can kind of put into squares and circles or whatever. It is every area, again, is kind of distinct and unique as far as the number of wells that are drilled, the operators and owners that are involved in these leasing areas.

And just in my opinion, I think there would have to be an evaluation of the producers and operators in an area, say, working together with the MMS to see what the pluses and minuses are of doing that in specific areas. I really believe you have to look at overall areas for these types of programs and situations just because it is just the way things are, quite frankly.

Smaller volumes to me don't make any sense to mess with. I think that the larger volumes—that is where you have the opportunities to try to capture better margin or premium in the market—I mean, if you can do that. In today's market environment and pric-

ing the way it is, you know, these premiums are hard to come by, at least it has been over the last few years because of the supply situation.

But at any rate, I think you have to look at the measure-producing areas, and, again, I would volunteer Enron Oil & Gas as a participant with the MMS to undertake—that in here as we write.

Mr. THORNBERRY. Well, would it be specific enough to say to have a mandatory program in the 8(g) waters off the coast of Texas? Is that a zone that is specific enough that you could make a determination whether it would work or not, or do you have to divide that up further?

Mr. HOYLE. I am embarrassed to admit that the 8(g) waters—you are talking about the State waters of Texas—just the State waters or——

Mr. THORNBERRY. Yes, or the Federal. Yes, the Federal. All right. Because in Texas it goes further than in other States.

Mr. HOYLE. Right. Well, as far as the OCS waters go, the way the transportation networks and systems are set out, they are very complex and many. So, again, I am sorry I can't get off this broken record of looking at individual areas, but that is kind of where I am headed once again.

Mr. THORNBERRY. OK. Well, let me ask you this. Would there be any complications that would arise, say, if the State took production in-kind but MMS did not in those waters, if you have two governmental entities that are operating under two different systems?

Mr. HOYLE. If it would be set up where the State would participate like a nonoperating working interest owner and go through the same operating conditions that a working interest owner does to try to market that gas, that it would just add just another owner to the situation that you are already in. It doesn't seem like just offhand that that could be too burdensome, but, again, I would like to look at it in some more detail just to make sure.

Mr. THORNBERRY. Sure. Mr. Nichols, several times today a number of us have talked about how a royalty-in-kind program would help in dealing with problems of valuation and administrative expenses—the lawsuits that you get into from all of that. But I don't think we have addressed yet how big a deal that is. You can say administrative expenses and problems of valuation, but can you address how important is it to basically solve disputes over valuation? How big a burden is that on producers, and how much advantage is there to getting that sort of program?

Mr. NICHOLS. Well, that is a significant burden, and it is a burden that is growing. That is attested to by the burgeoning number of lawsuits on that very issue. Litigation is, of course, an extremely expensive way to resolve disputes. And just the sheer burgeoning number of lawsuits on royalty questions is ample evidence that there has got to be a better way to provide simplicity and fairness to both sides.

One would like to hope that these pilot programs would lead to a royalty-in-kind program that both the government and the industry would be both enthusiastic about so that a mandatory program would be welcomed. It is perhaps premature to answer that question now because we haven't determined whether we can solve the problems that would allow us to all embrace a mandatory program.

Mr. THORNBERRY. So you are going to need to, for example, look at the contracts and the administrative burdens and that sort of stuff that would go with the mandatory program for you to know for sure whether you want to put your arms around it or not?

Mr. NICHOLS. Right. Precisely.

Mr. THORNBERRY. OK. I don't blame you a bit. Mr. Patterson, I thought you made an interesting point that if you move to, say, a total royalty-in-kind program that you have to take into account existing contracts. Because if you take away a certain volume from existing producers, they have to make it up some way. How long or for what time period are typical contracts now? In other words, what sort of contracting timeframe do we need to be concerned about?

Mr. PATTERSON. Well, generally, they can be long-term contracts, say, five, ten years—things like that. Or on a gathering system, you might have to commit to a firm transportation in order to save—to get a discount from the gathering company. And you would have to commit a volume. Say, 100 BCF over time would get you a 2 cent discount off of a rate. And then if you don't move 100 BCF, you have to pay or you don't get the discount. And that could be several million dollars to the producer, and that would be the life of the lease. So it is not an insignificant problem.

Mr. THORNBERRY. Is it common to have 10-year contracts, for example?

Mr. PATTERSON. I don't know. When you say common——

Mr. THORNBERRY. I am just trying to get a feel for how widespread that sort of long-term contract is. Mr. Hoyle, can you shed any light on that question?

Mr. HOYLE. Mr. Thornberry, 10-year agreements at least in the areas that we produce the market gas are really uncommon. In the marketplace nowadays, in our opinion, there is not much value added to a really long term type of agreement. There is some, but it is not great enough to tie down your production for an extended period of time.

As far as a range of contract terms, I would say the most that we do as far as term type of a commitment right now would be like four years. Maybe we will do a wintertime five-month deal—something like that. But most of the stuff that we do is sold on the spot market-type basis.

Mr. THORNBERRY. So what do you think about this phased-in deal? Do you think it needs to be phased in over a period of time, and, if so, what sort of time?

Mr. HOYLE. I would say that sounds like a reasonable and a good idea to phase it in over time. I think that would allow you to evaluate the producing areas and design a program that will be most beneficial and reciprocal for the MMS, States, and the industry. And, Mr. Thornberry, as far as what time period, I really couldn't hazard a guess on that. Maybe over like a three-year period, something like that.

Mr. PATTERSON. Mr. Thornberry, may I clear something up?

Mr. THORNBERRY. Certainly.

Mr. PATTERSON. With respect to when I was referring to contracts, there are certainly some warranty contracts out there where a producer has agreed to sell gas to an end-user for a period of

time. Those tend to be longer term. Then there are the transportation contracts, which can be for a lot, so those are distinct, and both are still being entered into today, I believe.

Mr. THORNBERRY. OK. Thank you. Mr. Hoyle, you mentioned something about market clout that comes with the greater volumes—having control over greater volumes. It would just seem to me that that would certainly apply to this situation with MMS, would it not, that this pilot program—let me ask you this way.

Would it be true that the pilot program may underestimate somewhat the ability to market the gas because we are dealing with a small quantity, and if we are dealing with a larger quantity that they might be able to get a better deal? Is that true or not?

Mr. HOYLE. Well, I would just say from a market clout standpoint, if you have a large volume of gas, say, in excess of 10,000 MMBTUs per day, one of the things that you can do is split that volume up and sell it to the other purchasers.

Like you can take two 5 million-a-day segments and bid it out and see if you couldn't get better pricing in doing something like that. Or you could take that 10 million-a-day package and do some kind of a warranty-type transaction or longer term commitment for just a piece of it.

Because, again, the way the market works nowadays, what the purchasers are looking for is a volume delivered at a point, and they want that volume to show up every day, every hour. But, see, you have to warrant that that volume will show up.

Well, if you have a 10,000 MMBTU segment of gas so you could warrant 4,000—5,000 MMBTUs per day of that, that would give you some excess gas above that to allow for some downtime or natural depletion of the reservoirs so you can make sure that that gas volume did show up.

And typically with a warranty-type situation, you probably could get a little bit better price, but within the last couple of years with the supply situation being pretty strong, we have not seen any real benefit in doing those kinds of things. Now, it appears to us that the supply-and-demand situation is changing, and you could maybe capture more of a premium by doing that. It hasn't happened here just recently, at least in our experience.

Mr. THORNBERRY. Until this winter at least, we had plenty of supply, didn't we? Mr. Chairman, if I may add just finally, Mr. Nichols followed up on Mr. Abercrombie's point. Do you think lots of other folks are interested in the idea?

One of you talked about that you haven't had any formal conferences talking about it but informal discussion. And among the people that you deal with and talk with, do you think that there is interest in this sort of approach among those people who are in the business?

Mr. NICHOLS. Oh, yes, I definitely think there is interest. There is concern as there always is with change, with new ideas. There is concern about how it might work and wanting to make sure it does work more properly. But there certainly is interest in the idea because we all recognize the difficulties that both we and the government have with the current system.

Mr. THORNBERRY. Thank you.

Mr. CALVERT. Thank you, Mr. Thornberry. And I want to thank this panel for your excellent testimony and coming forward today. We had some trouble with some of the major oil industry's reluctance to come out and testify today so we are grateful to you that you came out this long distance to give us some valuable information. Thank you very much. This Subcommittee is adjourned.

[Whereupon, at 3:36 p.m., the Subcommittee was adjourned; and the following was submitted for the record:]

Testimony of

Cynthia L. Quarterman, Director

Minerals Management Service
U.S. Department of the Interior

Before the

Subcommittee on Energy and Mineral Resources
Resources Committee

House of Representatives

June 27, 1996

Mr. Chairman and Members of the Subcommittee, I appreciate the opportunity to appear today to present testimony on the Royalty Gas Marketing Pilot (pilot), which was implemented by the Minerals Management Service (MMS) in 1995. The pilot was one of the National Performance Review (NPR) labs implemented by the Department of the Interior and represents one of our many efforts to provide better service to the public at reduced cost.

The MMS gas pilot was conducted from January 1, 1995, to December 31, 1995, and tested the concept of MMS taking the Federal Government's royalty share of gas production in-kind from offshore federal leases and selling the gas at or near the leases to competitively chosen gas marketing companies. The royalty gas was provided by 14 lessees on 79 leases who volunteered to participate in, and helped MMS design, the pilot.

The MMS had two objectives in conducting this pilot: 1) to find processes for streamlining royalty collections in a manner that reflects changes that have occurred in the gas market; and 2) to test a process of royalty collection that promises increased efficiency and greater certainty in valuation. We are pleased with the results of the pilot. It has provided the information required by the Federal government to evaluate the potential of using in-kind royalty collection for gas.

During the pilot, MMS took, in kind, approximately 45.6 billion cubic feet of gas, totaling over 6 percent of the Federal government's royalty share in the Gulf of Mexico and sold it to gas marketing companies. The marketers were responsible for all costs downstream of the points of delivery. They also retained all proceeds from selling the gas to their customers in a free market environment.

The MMS plans to issue a report on the pilot results later this summer. My testimony today will address only the main conclusions from the report. We will provide the Committee with a copy of the report as soon as it is completed. Based on the results of this pilot , MMS is considering whether to pursue additional royalty-in-kind efforts, and if so how and where to conduct them. We will keep the Congress informed of our progress in deciding whether to proceed and where.

Background

The pilot was a dramatic effort by MMS to do business in a different manner in response to recent changes in the gas marketplace (post FERC-Order 636). The MMS is testing the concept of removing itself from the complex practice of determining the appropriate value of production and auditing whether companies have paid royalties based on an appropriate value. In traditional gas valuation, much of the complexity arises from the difficulty in determining whether a non-arm's-length transaction represents the true value of the gas. We face additional complexity because of the problems inherent with calculating whether and to what extent certain costs incurred after production (e.g., transportation, processing, marketing) are deductible from the royalty value.

In the pilot, the valuation procedure is simplified dramatically. The producer is responsible for reporting only the total gas production from the lease and the royalty share of that gas delivered to the marketer. The marketer reports and pays MMS on the basis of the volume taken and the price/ MMBtu at the lease, which is the price the marketer bid for the gas in the competitive selection. Thus, production volumes become the sole focus of any audits.

The MMS designed, and has evaluated, this project in collaboration with its customers. This is an experimental effort to develop a regulatory approach that complements industry practices instead of adding burdens.

Some of the key features of the pilot include the following:

- The leases included in the pilot were volunteered by the participating lessees.

- The agreement establishing the procedure for taking of royalty gas was negotiated by the MMS and the lessees who volunteered to participate in the pilot.

- The MMS competitively selected marketing companies by issuing an open Invitation for Bids (IFB) on October 21, 1994. MMS opened the bids on November 21, 1994.

- The IFB instructed bidders to submit bids for each lease or group of leases identified by MMS. The bids were to be stated in terms of a published index price e.g., plus or minus a differential.

- Bids were based on the value of the gas at the Point of Delivery with the marketer responsible for costs incurred downstream of that point.

- The MMS received 23 bids from 22 companies, and ultimately awarded 13 contracts.

Royalty gas valuation, determination, and collection procedures have been subject to debate and litigation for years. Recently, MMS has undertaken several initiatives to attempt to find ways to streamline these processes without sacrificing royalty revenues. One of the attempts was gas pilot.

The procedures employed in the pilot were made possible by recent deregulation of the gas industry. Since the Natural Gas Policy Act of 1978, the gas industry has experienced several phases of deregulation including the decontrol of wellhead prices, the open access regulations for pipelines contained in Federal Energy Regulatory Commission (FERC) Order 436 and the formal separation of pipeline company sales and transportation services accomplished in 1993 by FERC Order 636.

This deregulation has transformed the U.S. gas market in at least two important ways. First, wellhead prices for gas are now determined by competitive forces to a much greater degree. Second, marketing companies have emerged that provide the services required by buyers and sellers in today's gas market. These changes have improved the efficiency with which gas is marketed and allow the MMS to take advantage of the competition between marketing companies for in-kind royalty gas offered at or near the lease.

Results of the Pilot

In general, we are pleased with the gas pilot. We acquired information and experience that will be invaluable in deciding how to proceed with any future gas royalty in-kind efforts. In particular, I would note the following results:

- The pilot was an operational success, proving that the concept is feasible. Our experience demonstrated to us that the procedures employed in the pilot can function smoothly once producers and marketers have a clear understanding of their respective responsibilities.

- The fact that MMS designed and evaluated the pilot in collaboration with its customers must be considered a critical factor in the pilot's operational success. For example, MMS negotiated directly with lessees on the terms and conditions for accepting the in-kind gas. This cooperative atmosphere also facilitated learning and flexibility.

- We are still working on our revenue impact analysis for the pilot. Our preliminary estimates indicate some royalty revenue loss for the gas production covered by the pilot. However, this is not entirely unexpected or unreasonable because we built in a 5 percent tolerance. The most important aspect of this pilot was to gain information and experience on taking royalty in-kind.

- MMS learned several lessons from the pilot that we feel will be useful in raising revenues in future royalty in-kind efforts.

    I. We know that all of the participants in this pilot needed considerably more lead time than what was allowed. This need

was particularly evident for gas marketers bidding for the Federal royalty gas. Also, MMS needs additional time to verify physical gas flow and to determine appropriate gas price indices.

II. We have learned that additional information must be included in the IFB. For example, future IFB's should include all gas analysis information (including Btu content) and the names of producer contacts who can provide information on transportation costs and gas flow.

III. Because of time constraints, we started this pilot in the middle of the winter season. We have learned that an auction of royalty gas should be conducted well before the start of the winter season so that gas marketing companies can integrate the availability of the gas into their winter gas contracts. By addressing each of these lessons in future royalty in-kind efforts, we feel that we can reduce the uncertainties faced by bidders and raise the level of bids so that revenue losses are reduced.

However, even in light of what we have learned, it is unlikely that the revenue losses can be completely eliminated. The reason is that the bids for the in-kind royalty gas reflect the fact that marketing companies must incur certain costs for marketing gas that was normally borne by lessees. Also, the marketing companies must also pay for the use of producer owned pipelines at rates that may be higher than the transportation allowance that lessees are able to deduct when paying gas royalties on an in-value basis.

- The MMS is also conducting an analysis to estimate the internal (MMS) administrative cost savings that can be achieved through the use of gas royalty in-kind procedures instead of conventional royalty valuation.

- Participating lessees indicated that they anticipated administrative savings if MMS were to institute a Gulf-wide gas royalty in-kind program. These savings would be realized through reductions in reporting requirements, audit interface, and litigation.

While MMS intends to consider conducting additional pilot projects, there is one statutory constraint that could limit MMS' ability to conduct such projects on a significant scale on the Outer Continental Shelf (OCS). The problem for MMS arises because of the way in that the OCS Lands Act (OCSLA) defines and uses the term "fair market value." The Act appears to stipulate that in the selling of royalty gas taken in kind, MMS must obtain a price no less than that obtained by the lessee for its share of the production. Based on results of the pilot, it appears that MMS would encounter difficulty meeting this standard for each lease, each month. The MMS would be pleased to work with the Subcommittee to develop clearer legislative language that allows greater flexibility in defining the fair market value standard.

Conclusion

In conclusion I would like to emphasize that this pilot represented the true spirit of MMS's efforts to find ways to make our royalty management efforts more efficient and less burdensome for the industry. We worked with industry to design an efficient program that reflects procedures that have evolved in the industry and serve both their needs and ours. We have also been encouraged by industry's willingness to work with us in evaluating the results of our combined efforts. At the same time, we sought to structure the pilot in such a way as to ensure a fair return to the public from production of its resources.

We are evaluating the results of the pilot carefully to see how we can best move forward to reduce costs, both for government and industry, without compromising royalty collections. Please be assured that we will keep the Subcommittee apprised of our progress in evaluating the pilot and in considering whether to conduct future gas royalty in-kind efforts.

Mr. Chairman, this concludes my prepared remarks. However, I would be pleased to answer any questions you or other members of the Subcommittee may have.

Written Statement by
Larry Nichols
President and Chief Executive Officer
Devon Energy Corporation
representing
Independent Petroleum Association of America (IPAA)
before the
Committee on Resources
Subcommittee on Energy and Mineral Resources
U.S. House of Representatives
June 27, 1996

Mr. Chairman and Members of the Committee:

I am Larry Nichols, president of Devon Energy Corporation ("Devon"), an independent producer who has federal production. I am here today on behalf of Devon and the Independent Petroleum Association of America ("IPAA"), a national trade association representing more than 5,500 independent oil and natural gas producers.

Mr. Chairman, members of the Committee, we always appreciate the opportunity to work with you in the pursuit of more efficient and cost-effective ways of managing the payment of federal royalties. In June of last year, I testified before you about the need to reform the federal royalty collection system. I personally want to thank you and the committee for responding by expeditiously moving your Royalty Fairness Bill.

Today, we are discussing another important initiative -- reducing uncertainty associated with the payment of federal royalties in today's natural gas market. We applaud the Minerals Management Service's (MMS) recognition that alternative approaches need to be pursued to develop a more certain and predictable method of determining gas royalty payments. Independents have participated in two of MMS' efforts to change the way they conduct business in the new gas marketplace. Gas production is important to this country and is important to independents, who produce 65% of domestic natural gas. We need to develop a federal royalty system that encourages gas production from federal onshore and offshore leases and, as required by law, always looks to the free and competitive market between a willing buyer and a willing seller as the basis for all royalty payments.

One of the two efforts initiated by MMS, which is not the subject of today's hearing, is the Federal Gas Valuation Negotiated Rulemaking Committee. This Negotiated Rulemaking Committee explored alternative valuation methodologies that would reduce the need to trace federal gas molecules through a myriad of complex marketing transactions in an attempt to determine market value at or near the lease. The IPAA participated in the last official meeting of the Negotiated Rulemaking Committee

in an attempt to find common ground among large and small producers. The IPAA supports an alternative valuation method for gas production and an option to eliminate the burdensome accounting associated with gas processing by allowing payment on a wellhead heating value. This proposal addresses in an equitable manner MMS' concerns about administrative burden, state concerns about revenue neutrality, independent concerns about audit burden and cash flow, and everyone's need for a simplified valuation methodology.

The MMS' second effort, to reengineer and increase certainty of gas royalty payments, is the topic of today's hearing. The effort is called the Gas Royalty-In-Kind Pilot Program (pilot). The MMS asked volunteers with production in the Gulf of Mexico to offer royalty gas for participation in a test in-kind program. Devon participated in the test in-kind program with one federal lease. We appreciated MMS' cooperative spirit of bringing different types of lease forms into the pilot.

For our volunteered lease on the volumes that were attributable to royalty in-kind, Devon replaced the accounting burdens associated with a monthly royalty payment with additional gas control responsibilities. Under the pilot, we were required to notify the government's purchaser of the volume of gas that it was required to take. This additional communication and new relationship with MMS' purchaser appears to replace the administrative costs associated with reporting royalty in value.

Royalty Payments in today's new gas marketplace

Between the late 1940s and the 1970s, when a new well was drilled, a producer would negotiate and execute a gas sales agreement with an interstate or intrastate pipeline for the purchase and sale of gas at each new well. The pipeline would then construct a transportation (gathering) line to the new well for receipt of the gas into its pipeline system. Gas was sold and flowed directly into the interstate or intrastate pipeline "at the well." The pipeline moved the gas through its transportation system to its processing plant, if necessary. The pipelines purchased the gas at each well and transported it away from the well to local distribution companies, who sold it to localized industrial, commercial, and residential customers. Because the pipelines bought and resold gas, they functioned as gas merchants and were referred to as "merchant pipelines."

Gas was sold at the well to the pipelines at a price which represented the value of gas in its naturally occurring state at the point of production. For royalty purposes, it has been recognized for over 50 years that the price paid to the producers by the pipelines constituted the "market value at the well" for the royalty gas produced under the lease contracts.

Beginning in the mid-1980s, gas marketing changed dramatically as a result of the Federal Energy Regulatory Commission's ("FERC") initiatives to inject more competition into interstate gas markets. In 1985, FERC issued Order No. 436 which

required interstate pipelines to provide "open access transportation" to all producer shippers on a nondiscriminatory basis. Order No. 436 completely restructured the national gas industry and began changing the role of pipelines, from that of gas "merchants" to that of gas transporters. In obtaining "open access" to pipeline transportation, producers could now transport on pipelines and sell directly to prospective customers throughout the nation.

Subsequently, FERC Order No. 636 mandated the "unbundling" of the pipeline's various sales and transportation functions and other services, and further implemented the open access transportation policies initiated by Order No. 436. As a result of these regulatory changes, interstate pipelines have virtually ceased to be purchasers of gas and instead now function almost solely as transporters of gas owned by others.

As a result of these sweeping changes, potential markets for the sale of gas were greatly expanded. Producers may now sell directly to industrial customers, end-users, local distribution companies, and other former interstate pipeline customers. Rather than sales occurring at the wellhead, as was historically and customarily done during the first 50 years of gas production, producers now must either build transportation lines to transport gas away from their wells or pay third parties to transport gas away from the wellhead for shipment to distant markets. When a producer sells gas away from the well, the producer must incur the cost and expense of getting its gas to that distant point of sale. The "wellhead" price for "any away from the well" sale can be calculated by using a "net back to the well" method, which results in a price that is net of the costs incurred to get gas to the market. A producer taking advantage of today's marketing flexibility by selling downstream of the well, directly incurs charges for such functions as transportation, compression, and processing that were previously reflected in an interstate pipeline wellhead sales price. Prior to this regulatory restructuring of the industry, these functions were generally performed by interstate pipeline purchasers as part of their "bundled" merchant service.

The changing marketing arrangements did not easily conform to the current regulatory structure. As companies sell away from the well, "netting back to the well" to determine value can be administratively complex and increase uncertainty as costs once considered deductible as a cost for "bundled" merchant services are now being tracked and reviewed for royalty purposes. The need for regulatory change for gas production was recognized by MMS in a report it issued in March 1995 entitled "Final Report Federal Gas Valuation Negotiated Rulemaking Committee," which states that "tracing proceeds from sales of gas back to a particular lease is very difficult, and determining the royalty value of gas produced from federal leases has become increasingly complex and burdensome."

Why MMS and producers pursued a gas royalty in-kind project

As stated above, the MMS has acknowledged that the current royalty payment system for gas does not compliment the gas marketplace. When MMS takes its royalty gas in-kind at the wellhead, it relieves the government and lessee of the uncertainties and complexities associated with gas sales occurring at locations remote from the lease. The MMS stated in a press release that the pilot "evolved out of discussions with our customer and typified doing more with less. It is a true example of reinventing government, MMS trying new business practices and procedures to work better and smarter."

A mutual benefit to the government and the producer is the certainty associated with delivering volumes in lieu of royalty payments. Once delivered, the royalty obligation under the lease is satisfied. One question always asked is what is market value? When taken in-kind, market value is the price that the MMS receives from the willing purchasers. In-kind provides flexibility for both the MMS and the natural gas producer in an ever changing and evolving gas market in North America.

While my comments today have been general in nature, we have attached additional background with regard to a royalty in-kind program. The attachment highlights factors that need to be considered that could affect the outcome of an in-kind program. To facilitate continued cooperation between MMS and industry for experiments, such as in-kind, we suggest that MMS allow volunteers and purchasers involved in the pilot to comment on its draft of the report about the in-kind project. Much of the data and information being used by MMS in its report was supplied by participants in the pilot.

For an official analysis of the MMS pilot, we refer you to a paper prepared for the Rocky Mountain Mineral Law Foundation's 41st annual institute. This paper is entitled "Testing the Water: A Cooperative Effort to Design the MMS' Royalty In-kind Pilot Program for Natural Gas."

Conclusion

We compliment and encourage MMS to continue to work cooperatively with the industry and states to develop alternatives that restore certainty and create simplicity for paying royalties on natural gas production. In this regard, Devon has volunteered gas for an in-kind onshore pilot. A second pilot will serve as a learning experience as we move forward.

Mr. Chairman, we support the legislative language you submitted to the Chairman of the Subcommittee on Interior Appropriations authorizing MMS to conduct additional in-kind pilots. If these pilots are conducted in a manner similar to your language -- "at or near the lease on a volunteer basis in an onshore area with active gas

markets" -- then all concerned parties would be better able to make informed decisions about the future of such a program.

I want to inform the Committee about a separate effort that we have initiated to develop alternatives to the current royalty payment system to better compliment today's gas market. As chair of an advisory subcommittee for the MMS entitled "Nonconventional Alternatives," we will develop payment options to reduce royalty regulatory burdens associated with gas production. Potential alternatives include an extended period for reporting gas transactions to accommodate the thousands of adjustments associated with tracing gas sales back to the well, taking gas in-kind, and buying out royalty streams. This subcommittee is comprised of industry, state, and Native American representatives. When this subcommittee develops recommendations we will submit them to the committee for its review.

As the demand for natural gas increases from domestic sources, we must reverse the trend of independents not increasing their development of gas resources from public lands, an important source of undiscovered gas. Devon and IPAA encourage the Committee to continue with its oversight of activities to improve the state of natural gas production from federal lands. To encourage additional development, independents cannot be required to pay royalties on values which exceed the proceeds received for the sale of gas at or near the lease.

Thank you for this opportunity to testify. There are a number of options, such as royalty in-kind, that need to be pursued as ways to reduce costs and streamline the royalty payment process for gas production. There is much to be learned about a royalty in-kind program from a federal and state government and industry standpoint. We are available to work with the committee as the process for developing alternatives for paying royalties on gas production moves forward.

Attachment 1

What primary factors affect the outcome of an in-kind program?

The Mineral Leasing Act and the Outer Continental Shelf Lands Act require that the amount of royalties due the government be paid in full the month following the month of production. To ensure proceeds were deposited with the Treasury within the required timeframe, the MMS chose to immediately transfer, or "flip," title of the gas delivered by the producer. The MMS chose not to expend any costs and/or take any risks associated with downstream value-added gas sales activities.

The MMS felt that this payment requirement contained within the law prevented them from entering into any sort of gas balancing or storage situation. These restrictions were passed onto the competitively selected purchaser of the gas which prevented purchasers from entering into traditional balancing arrangements thereby affecting the price received for the gas. The requirement for the purchaser to take all produced volumes may require the purchaser to obtain firm transportation in lieu of interruptible transportation, which could be a more costly proposition.

Other factors affecting the success of an in-kind program:

1. To achieve maximum efficiency, reporting and auditing should be limited to production reports and communication regarding available volumes, including imbalances.

2. Gas balancing should be designed to minimize impacts on the producers and the government. Once production occurs, which is under the sole discretion of the lessee/producer, the lease requires royalties to be paid. The producer cannot segregate the royalty share of production to be left in the ground.

3. An in-kind program cannot interrupt a lessees existing processing and marketing arrangements. When gas is taken in-kind, there should be sufficient notice as not to disrupt existing marketing arrangements.

4. For every federal lease, the MMS or the Bureau of Land Management approves a royalty settlement point as the point of measurement consistent with the terms of the lease. It is imperative that under any in-kind program, production be delivered at this point.

5. States need to be consulted in all future in-kind efforts. If states begin marketing their share of the royalty stream, the entire royalty stream must be taken in-kind to prevent the additional administrative costs of multiple collection systems.

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6. Potential purchasers need to have more timely access to information affecting the bids. This includes mapping of actual flow, a longer time before purchasers have to submit bids to understand supply source, cost data regarding non-regulated lateral lines owned by the producer, and the quality of gas being purchased.

7. An in-kind program should not be unnecessarily burdened by an examination of other sales occurring in the area to determine if an in-kind sale received market value. A sale of in-kind volumes by MMS is market value because it is the agreed-to price between a willing buyer and seller at the time of the sale. To clarify this important point, a legislative change may be required.

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